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ADVANCED MARKETS INSIGHT

Supplemental Executive Retirement Plans

M Financial Group's Advanced Markets Insights are designed to help clients understand sophisticated planning strategies and their applications.

M Financial Group continues to lead the industry in insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

What is a Supplemental Executive Retirement Plan (SERP)?

A Supplemental Executive Retirement Plan (SERP) is a form of non-qualified deferred compensation for a selected group of executives. In a SERP, the employer and the executives enter into an agreement in which the employer promises to pay future retirement benefits. In doing so, a deferred compensation liability is created which the employer will account for annually.

Funding the SERP Liability

Although the plan generally involves only the employer's unsecured promise to pay benefits, security to the executive is often provided through informal financing arrangements such as Corporate Owned Life Insurance (COLI). To segregate the funds earmarked for deferred compensation purposes, many plans also utilize a specialized device known as a Rabbi Trust.

Corporate Owned Life Insurance

Corporate owned cash value life insurance is often chosen as the financial vehicle used to fund the SERP liability because of the benefits it offers the employer.

With this form of life insurance, policy cash values:

- Accumulate tax-deferred
- Can be considered a corporate asset
- May be accessed to meet the SERP liability by way of tax-free policy loans and withdrawals[1]
- Are available to the employer for use at all times

The death benefit of the insurance can be used to:

- Reimburse the employer for premiums paid
- Provide money to fund retirement benefits for other executives
- Provide a survivorship benefit to an employee's heirs, should the employee die prior to receiving all of his/her deferred compensation

As the name implies, COLI is purchased by the employer and insures the lives of its employees. Each employee must consent to the purchase of the insurance policy.[2]

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1 Subject to the rules and regulations of IRC Section 7702; policy withdrawals, loans, and loan interest will reduce policy values and may reduce benefits.

2 IRC Section 101(j).

Rabbi Trusts

Although it is not required, a Rabbi Trust can be used to segregate deferred compensation assets from the employer's general funds. A Rabbi Trust is an irrevocable trust in which an employer deposits deferred compensation payable to its employees, but where the trust's assets remain subject to the claims of the employer's creditors.

Advantages of Establishing a SERP

- A SERP can save the costly expense and administrative burden of maintaining a qualified plan such as a 401(k) or supplement a plan already in place through additional benefits to key employees.
- The employer is free to choose which employees will be participants without violating any anti-discrimination requirements, as long as the plan is limited to management and highly compensated employees
- Almost any vesting schedule can be used, and the plan can be constructed so employees will forfeit benefits under specific circumstances, such as misconduct, resignation to work for a competitor, or termination of employment before retirement, thus creating a powerful employee retention device

Considerations

- SERPs, employers, and employees must comply with Internal Revenue Code Section 409A, enacted in 2004, which regulates many aspects of deferred compensation
- SERPs are not appropriate for all employers:
  - The employer must last long enough to make the payments promised under the plan, as the full tax benefits of the plan cannot be provided unless the employer exists at the time of payment so it can take its tax deduction
  - Because of their pass-through tax structure, S corporations and partnerships may find non-qualified plans, such as SERPs, useful for key employees who are not signifigant shareholders
  - Additional restrictions exist when non-qualified plans are used in tax-exempt or governmental organizations

Overview of Non-qualified Deferred Compensation Plans

A deferred compensation plan that is "non-qualified" is one that that falls largely outside the provisions and purview of the Employee Retirement Income Security Act (ERISA). Non-qualified plans do not receive some of the tax benefits associated with ERISA-conforming "qualified" plans.

The primary difference between a qualified plan and a non-qualified plan is that non-qualified plans do not generate an income tax deduction for the employer during the employee's working years. Instead, the employer must wait until the year in which deferred compensation is actually distributed to its employee to take its deduction.

However, a non-qualified plan can provide tax deferral for the employee, as well as meet employer and employee compensation objectives.

Comparison to a Qualified Plan

Non-qualified plans are similar to well known qualified retirement plans, such as 401(k)s and 403(b)s, with a few key differences.

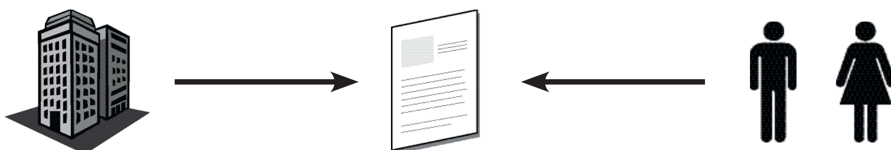
Comparison to a Qualified Plan *(Continued)*

Unlike qualified plans, a non-qualified plan:

- May be offered solely to a select group of managers or highly compensated individuals[3]
- Allows the employer to tailor benefit amounts, terms, and conditions for different employees
- Is not subject to an annual limit on the amount of benefits it can provide (though it may only deduct amounts that are "reasonable compensation" for a given employee)[4]
- Involves reduced IRS, ERISA, and other governmental regulatory requirements, including reporting and disclosure, fiduciary responsibilities, and funding requirements

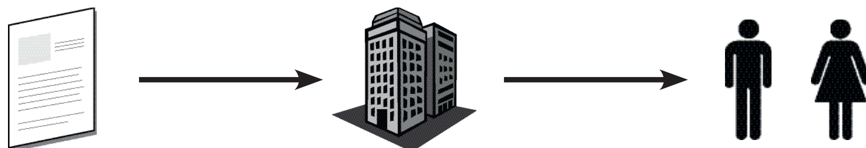
Supplemental Executive Retirement Plan

1. The employer and employee enter into an agreement in which the employer promises to pay the employee a future retirement benefit.

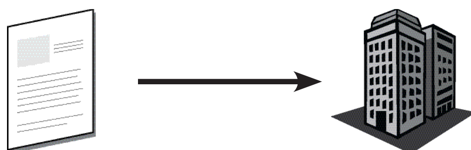


2. The employer obtains a life insurance policy (COLI) on the life of the employee, with the employee's consent.

3. At retirement, the employer accesses policy cash value via tax-free loans and withdrawals to fund the retirement income payments to the employee.



4. At death, the employer will receive partial cost recovery via the death benefit of the policy.



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3 Under ERISA, if a non-qualified plan is unfunded and maintained by an employer for the purpose of providing deferred compensation for a "select group of management or highly compensated employees," the plan is exempt from all provisions of ERISA, except for the reporting and disclosure requirements, and ERISA's administrative and enforcement provisions.

The reporting and disclosure requirements can be satisfied by providing plan documents, upon request, to the Department of Labor, and by filing a simple, one time statement about the arrangement with the Department of Labor.

4 IRC Sections 162 and 83.

For More Information

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